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SUBJECT: MADRID WEEKLY ECON/AG/COMMERCIAL UPDATE REPORT

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ECON: Spain's industrial economy
EFIN: Macroeconomics
EAGR: Spanish Wine sector may lose subsidies

Spain Surpasses Canada in industry

¶1. (U) Standard & Poor says as of 2007 Spain is the eighth industrial economy in the world, thereby surpassing Canada: The S & P ranking in billions of dollars follows. U.S. (13.8), Japan (4.5), Germany (3.1), China (3.0), UK (2.4), France (2.4), Italy (2.0), Spain (1.3). Spain's debt rating is at the highest level, reflecting its good public finances. Occasionally, there is talk that Spain should apply for G-8 membership, but the Zapatero government has not made this a priority. Nor did the predecessor conservative government. If the gap between Spain and Canada widens though, there will no doubt be more debate on this topic in Spain.

Macroeconomic Perspectives

¶2. (U) President Zapatero predicted at the 1/17/07 New Economy Forum that the Spanish economy in 2007 will grow by 3.5 percent, that the budget surplus will be over 1 percent of GDP, that public debt will be reduced by about three points (which would put it 30 points below the Eurozone average), that Spain's unemployment rate will be under 8 percent, that 600,000 new jobs would be created, and that 500,000 people with temporary job contracts will get permanent contracts. Many observers believe that Spain has a better than even chance of meeting these numbers. Most politicians facing an election in 13 months time would find these numbers outstanding.

¶3. (U) The economic news is not uniformly good though. A sampling from newspapers follows. Expansion reported on January 16 that inflation in 2006 (roughly 3.5 percent) was depleting the real value of nominal wage increases. Immigration had been an important factor in keeping wage increases down. In fact, in 2006 employers spent less on wages and benefits than in 2005. The opposition Conservative Party (PP) economic spokesman, Miguel Agrias Canete, focused on Spain's widening current account deficit, which in 2006 approached 8 percent of GDP. Canete said despite being a Euro nation, Spain could not expect to finance its current account deficit indefinitely. It could suffer a crisis like the one in Portugal. (Expansion, January 17). One reason for the increase in the current account deficit is that as

Spaniards get richer, they go abroad more so the tourism surplus that Spain traditionally relies on declines. (ABC, January 18). By November 2006, mortgages amounted to roughly 92 percent of GDP. (ABC, January 9). Household savings in 2006 fell to their lowest level since 1999 (ABC, January 16).

Foreign investment in real estate declined by 12.1 percent in 2006 compared to 2005, while Spaniards increased their real estate purchases overseas. (ABC, January 16).

14. (U) So who is right? The government or the opposition? The number two at the Ministry of Finance, David Vergara, conceded to the DCM that about a third of Spain's current account deficit reflected a lack of competitiveness. But financing for the foreseeable future would not be a problem, among other reasons because Spain, unlike Portugal, continues to run a budget surplus. And yes, mortgage lending is up, but most mortgages were generated with a loan to value ratio under 80 percent, suggesting that negative equity problems stemming from a drop in housing prices is not likely. The opposition PP economic spokesman concedes a soft landing for the property market is more, rather than less, likely. So, for 2007, it seems that the government's optimism is warranted, although it clearly should be doing a lot more structural reform to make Spain more competitive.

15. (U) Where does the feel good factor among many Spaniards stem from? There are a variety of explanations but three stand out. First, 80 percent of Spanish households own their property, and they have seen their property values rise dramatically in recent years. Even if Spaniards do not typically extract equity from their houses and apartments, there is a wealth effect in terms of greater willingness to spend and borrow. Second, unemployment, while still high by American standards, is considerably lower than by historic Spanish standards. As observers in the U.S. have often noted, trends often matter more than the absolute numbers in terms of shaping public opinion. Third, with more women in the workforce, households are richer even if real wages are

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being eroded by inflation.

Spanish Wine reform policy

16. (U) The European Commission (EC) and the Government of Spain (GOS) endow Spanish producers and exporters with a competitive advantage vis-a-vis U.S. producers/exporters in markets of mutual interest via their wine policies. During marketing year (MY) 2006, we estimate that the EC and GOS paid Spanish wine producers about 460 million Euros in production, stabilization, marketing, and export subsidies. Of that total, Spanish producers received 158 million Euros in vineyard-restructuring subsidies to replace no-longer-desirable grape varieties with in-demand varieties such as Tempranillo, which will further enhance Spanish long-term competitiveness in the U.S. domestic market, and important third-country markets such as the United Kingdom.

17. (U) In June of 2006, the EC proposed reform of the wine sector with the stated intent of reducing the type and level of subsidies and moving the entire sector to a more market-oriented structure. However, Spanish producers, long accustomed to this exceptional financial assistance, are opposed to a reduction in aid. Rather, they counter propose that the EC and GOS provide even greater market-enhancement subsidies to create stronger demand and higher prices for their wine, which might then reduce some of the other production and stabilization subsidies currently being paid.

Aguirre